Profit Repatriation Strategies for Foreign Enterprises in China

Finnish Business Council Beijing
By Finnish companies for Finnish companies

*"FBCB's **mission is to help Finnish companies to success in China** through experience & knowledge sharing, networking and collaborative advocacy"*

Major industries: smart energy, ICT, technology innovations, cleantech, winter sport, logistics and travel, health tech, Finnish healthy living and lifestyle

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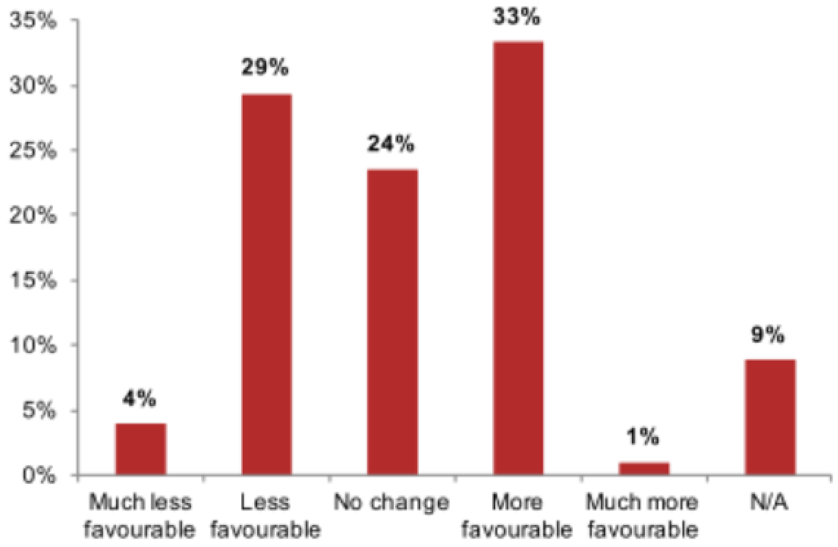
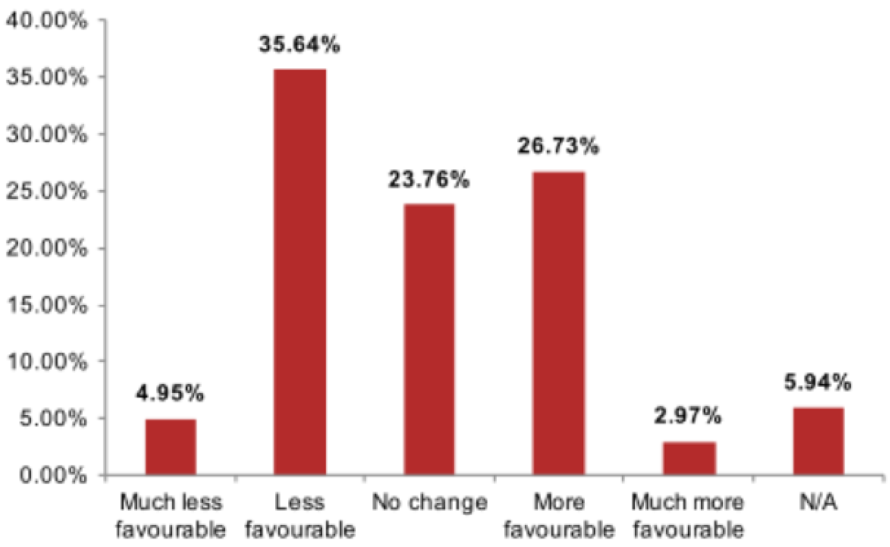
2021 Outlook

Expectation of the investment climate development in China/HK in 2021 vs previous year



Expectation of the business climate development in China/HK in 2021 vs previous year



- Slight majority of companies expect the investment climate to be more favourable in 2021, while the uncertain situation and localization pressures are driving the rationale for less favourable investment climate expectations based on the responses
- Majority of companies expect the business climate to be less favourable in 2021, highlighted by rising trade conflicts, global political tensions and uncertain regulatory landscape

Barriers and Reforms

Key barriers doing business in China/HK and kinds of reforms that would benefit the business

What are the key barriers doing business in China/HK?

- National protectionism, made-in-China-policy
- Lack of knowledge in Chinese business customs and regulatory landscape and regional differences
- US/China trade war and its implications to businesses
- Finding the right contacts and connections to affluent players and authorities
- Travelling restrictions during Covid-19
- Fierce domestic competitive landscape
- Lack of Intellectual Property Rights
- Highly priced products imported from Europe difficult for open bidding

What reforms in China/HK would benefit your business?

- Less favouring of local companies (protectionism)
- Reforms on policy implementations such as social insurance, taxation to make cost structures between companies fair
- Easier import regulation and procedures
- Less forex control and easier capital repatriation
- Environmental regulation and enforcement
- Governmental subsidy for SMEs
- Foreign access to strategic industries
- Recognize IP as part of financial investment
- Tender processes to focus more on life-time cost and quality

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Profit Repatriation Strategies for Foreign Enterprises in China

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Pierre has over 25 years experience in external auditing, financial advisory and business consulting for foreign companies in China. Prior to joining the Firm, he served in management positions as Head of Shanghai in KCS (now TMF), China Finance Director of CB Richard Ellis, as well as the Senior Manager of KPMG Shanghai office. Pierre has provided practical accounting and business advices to foreign companies over his past 17 years in China.

Pierre holds a MBA from Edinburgh Business School and a Bachelor degree in Chartered Accountancy from University of Waterloo. He is both a member of the Canadian Chartered Accountant and a Fellow Member of the Hong Kong Institute of Certified Public Accountants (HKICPA).

He started his career with Mackenzie Financial, a well respected Mutual fund company in Toronto, Canada before moving to China in 2004.

He can speak fluent Mandarin, English and Cantonese.

Agenda

- Dividends
- Service Agreements
- Royalties
- Foreign Loan Interest Payments
- Implications of Transfer Pricing in China

Dividends

Background

Dividends to shareholders are the most common method for FIEs in China to repatriate profits. Earnings are distributed to shareholders according to the equity shareholding in the company.

Facts:

- Must place at least 10% of net profits in a reserve account – up to 50% of the registered capital;
- Subject to withholding CIT of 10%;
- Preferential tax rates and exemptions sometimes granted under DTAA - ex. HK subject to 5% withholding CIT;
- Withholding CIT paid in China can be deducted from overseas tax liability.

Dividend Payments		
	Calculation	Amount
Profit	(a)	100
Corporate Income Tax	(b) = (a) x 25%	25
Mandatory Reserve	(c) = (a - b) x 10%	7.50
Withholding CIT*	(d) = (a - b - c) x 10%	6.75
Net amount for repatriation	-	60.75

* Withholding CIT paid in China can be deducted from the tax liability overseas under a DTAA.

Case Study: Dividend Repatriation

Company A:

Company A is a "Small and Micro-sized Enterprise" with profit of RMB 3million. Company A is 100% owned by a Hong Kong holding company.

Company B:

Company B is a "Large Enterprise" with RMB 30million in profits. Company B is 100% owned by a Finnish Company.

Company A		
Dividend Repatriation	Amount (RMB)	Tax Rate (%)
Profit	3,000,000	-
CIT*	250,000	8.33%
After Tax Profit	2,750,000	-
Profit for Reserve	275,000	10%
Withholding CIT	247,500	10%
Profit for Repatriation	2,227,500	74.25%

Company B		
Dividend Repatriation	Amount (RMB)	Tax Rate (%)
Profit	30,000,000	-
CIT	7,500,000	25%
After Tax Profit	22,500,000	-
Profit for Reserve	2,250,000	10%
Withholding CIT	1,012,500	5%
Profit for Repatriation	19,237,500	64.13%

* Small and Micro-sized Enterprises (SMEs) enjoy a preferential rate of 5% CIT for their first RMB 1million of profits and 10% CIT rate for profits of RMB 1million – RMB 3 million. Profits above RMB 3million are subject to 25% CIT. This policy is set to expire December 31st, 2021, unless renewed. Small and Micro-sized enterprises are those with less than 300 employees, total assets not exceeding RMB 50million, and taxable income less than RMB 3 million.

Dividends

Process

Step 1	Annual Tax Return filing & Annual Audit
Step 2	Drafting a Board of Director resolution on profit distribution and filing with relevant tax authorities
Step 3	Application for preferential tax treatment under DTAA (if applicable) and payment of withholding CIT
Step 4	Dividend remittance

Dividends

Other Considerations

- Dividends can only be paid from after-tax earnings following the annual CIT reconciliation – typically in June of the following fiscal year.

- Profits can only be repatriated after the registered capital is topped-up.

- Not all profits can be repatriated, 10% of profits must be placed in a mandatory reserve up to the 50% of the registered capital.

- Profits placed in the mandatory reserve can be freely invested back in the business.

- Preferential rate provided under DTAA requires economic substance in Country B. i.e. Cannot be applied if dividend is paid to a holding company.

Service Agreements

Background

Certain business functions may be carried out at the group level or by a related party in exchange for a service fee. Examples include accounting, HR, information technology, marketing, and other supporting functions that can be administered at the group level.

Facts:

- Subject to 6% withholding VAT and other local surtaxes;
- Profit derived from services are subject to 25% withholding CIT;
  - Deemed profit rate 15% ~ 50% based on the service type;
- Withholding CIT paid in China can be deducted from overseas tax liability under a DTAA.

Service Agreements		
	Calculation	Amount
Service Agreements	(a)	100
VAT	(b) = (a) / (1+6%) x 6%	5.66
Local Surcharges*	(c) = (b) * 12%	0.68
Withholding CIT**	(d) = (a) / (1 + 6%) x 30%*** x 25%	7.08
Net amount for repatriation	-	86.58

*Local Surcharges vary between cities and by district.

** Withholding CIT paid in China can be deducted from the tax liability overseas under a DTAA.

*** Based on a deemed profit rate of 30%.

Service Agreements

Process

Step 1	Contract preparation & contemporaneous documentation
Step 2	Application for preferential tax treatment under DTAA (if applicable)
Step 3	Withholding tax filing & payment
Step 4	Bank clearance & remittance

Service Agreements

Other Considerations

- Services rendered outside of China may be exempt from withholding CIT.
- Service contracts are no longer required to be registered with the relevant authorities but are still generally required for bank clearance and remittance.
- If the provision of services by non-resident enterprise constitute a **Permanent Establishment** (PE), income attributed to that entity will be subject to 25% CIT in China. An overseas entity is deemed to have PE in China if:
    - Its employee or other personal provide service in China, including related projects, for more than 183 days cumulatively within a 12-month period; or
    - Provision of services in China lasts more than 12 months.
- Payment under USD50k are not required to be approved by SAFE. Enterprises may make relevant tax disclosure and payment during the **next tax filing period**.

Case Study: Marketing Services

Party A: Regional Sales office in mainland China

Party B: Headquarters in Finland

Party A contracts Party B for marketing services. The agreement stipulates that Party A will pay Party B USD 300K per year for ongoing marketing services provided to them.

China tax law states that services rendered outside of China are not subject to China tax, unless service provisions constitute a permanent establishment (PE).

Service Agreements		
	Calculation	Amount
Service Agreements	(a)	100
VAT	(b) = (a) / (1+6%) x 6%	5.66
Local Surcharges*	(c) = (b) * 12%	0.68
Net amount for repatriation	-	93.66

*Local Surcharges vary between cities and by district.

VAT paid is deductible from output VAT

Services rendered outside China are exempt from CIT.

Royalties

Background

Royalties are fees paid to an entity in exchange for the use of intellectual property such as patents, copyrights, trademarks, or proprietary technologies. Their amount is typically calculated as a fixed amount or as a percentage of sales.

Facts:

- Subject to 6% withholding VAT and other local surtaxes;
- Subject to 25% withholding CIT on a deemed profit rate of 40%;
- Withholding CIT paid in China can be deducted from overseas tax liability under DTAA.

Royalties		
	Calculation	Amount
Royalty	(a)	100
VAT	(b) = (a) / (1+6%) x 6%	5.66
Local Surcharges*	(c) = (b) * 12%	0.68
Withholding CIT**	(d) = (a) / (1 + 6%) x 10%***	9.43
Net amount for repatriation	-	84.23

*Local Surcharges vary between cities and by district.

** Withholding CIT paid in China can be deducted from the tax liability overseas under a DTAA.

** The CIT rate is based on the standard 25% CIT rate for a deemed profit of 40%.

Royalties

Process

Step 1	Contract preparation & contemporaneous documentation
Step 2	Contract filing with local commerce bureau or Trademark Office;
Step 3	Application for preferential tax treatment under DTAA (if applicable);
Step 4	Withholding tax filing & payment;
Step 5	Bank clearance & remittance.

Royalties

Other Considerations

- Royalty agreements must comply with relevant PRC transfer pricing laws and regulations and be carried out in accordance with the *Arm's Length Principal* in order to be deductible.

- Chinese tax authorities hold the view that Royalty fees should be equal to how much value the company derived from the use of the intangible assets.

- Royalty agreements should be accompanied by detailed supporting evidence – including the rational for determining price.

Case Study: Design Services

Party A: Real estate company in mainland China

Party B: Architectural firm in Hong Kong

Party A contracts Party B to provide construction engineering designs. The agreement stipulates that Party B will retain ownership of the design and Party A will pay USD 1.1 million for use of the designs. Party B dispatches an employee to mainland China for 30 days consecutively during the contract period.

China tax law states that services rendered outside of China are not subject to China tax, unless service provisions constitute a permanent establishment (PE).

Question

1. Do the services provided by Party B constitute a Permanent Establishment in China?

2. Are the fee’s paid to Party A taxable in China or Hong Kong?

Foreign Loan Interest Payments

Background

FIEs in China are permitted to register foreign debt on which they can pay interest to the issuer of the loan. Business must specify a total investment which is greater than the registered capital on their Articles of Incorporation in order to to utilize foreign loan interest payments.

Facts:

- Subject to 6% withholding VAT and other local surtaxes;
- Subject to 25% withholding CIT on a deemed profit rate of 40%;
- Withholding CIT paid in China can be deducted from overseas tax liability under DTAA;
- The principal loan can be paid back to the investor at any time.

Foreign Loan Interest Payments		
	Calculation	Amount
Interest	(a)	100
VAT	(b) = (a) / (1 + 6%) x 6%	6
Local Surcharges*	(c) = (b) x 12%	0.68
Withholding CIT**	(d) = (a) / (1 + 6%) x 10%***	9.43
Net amount for repatriation	-	84.23

*Local Surcharges vary between cities and by district.
** Withholding CIT paid in China can be deducted from the tax liability overseas under a DTAA.
** The CIT rate is based on the standard 25% CIT rate for a deemed profit of 40%.

Foreign Loan Interest Payments

Loan Process

Step 1	Prepare the intercompany foreign loan agreement with parent company
Step 2	Registering foreign loan with State Administration of Foreign Exchange (SAFE)
Step 3	Open foreign loan bank account

Payment Process

Step 4	Application for preferential tax treatment under DTAA (if applicable)
Step 5	Withholding tax filing & payment;
Step 6	Bank clearance and remittance

Foreign Loan Interest Payments

Other Considerations

- Interest rate cannot exceed the official rate offered by Bank of China – generally around 4%.
- FIE's are permitted to register foreign debt up to the foreign debt quota.

Foreign Debt Quota = Total Investment - Registered Capital

Foreign Debt Quota & Registered Capital		
Amount of Total Investment (USD)	% of Minimum Registered capital to Total Investment	Note:
3 million or below	70%	-
3 million - 10 million	50%	Registered Capital not less than USD 2.1m
10 million - 30 million	40%	Registered Capital not less than USD 5m
30 million or above	1/3	Registered Capital not less than USD 12m

Transfer Pricing in China

Implications of Transfer Pricing in China

“The Arm’s Length Principle”

China’s Enterprise Income Laws provide the *Arms Length Principle* as the guiding principle for related party transactions and provide tax authorities the power to adjust a taxpayer’s taxable income if it fails to comply with the arm’s-length. The *Arms Length Principle* states that the conditions and amount charged by one related party to another for a given product must be the same as if the parties were not related.

Transfer Pricing Methods:

- Cost-plus method
- Retail price method
- Profit split method
- Other methods consistent with the arm’s-length principle.

Transfer Pricing Documentation

Background

According to the SAT Announcement [2016] No.42, enterprises with related party transactions above certain thresholds must prepare the contemporaneous transfer pricing documentation – known as the master file, local file, or special file. Additionally, **all enterprises with related party transactions** must make a related party transaction declaration during their year-end CIT filing.

Transfer Pricing Documentation		
	Scope of documentation	Filing deadline
Master File	» Enterprises who engage in cross-border related party transactions during the year, and the ultimate holding company that consolidates the financial statements of the enterprise has prepared the Master File; or, » Enterprises who's annual total related party transcations exceed **RMB 1 billion**.	Within 12 months of the end of the fiscal year of the ultimate holding company
Local File	» Enterprises who's amount of **tangible assets transferred** to related parties to exceeds **200 million yuan**; » Enterprises who's amount of **financial assets transferred** to related parties exceeds **100 million yuan**; » Enterprises who's amount of **intangible assets transferred** to related parties exceeds **100 million yuan**; » Enterprises who's total amount of other related party transactions exceeds **40 million yuan**.	Before June 30th of the following year
Special File	» Enterprises who signs or executes a **cost sharing agreement** with a related party; » Enterprises who's related party debt-to-equity ratio exceeds the standard ratio and needs to comply with the arm's length	Before June 30th of the following year

Transfer Pricing Disputes

Background

Tax authorities reserve the right to question the legitimacy of related party agreements and examine both parties involved. **All enterprises** should retain detailed documentation including agreements including the justification for pricing methodology and ample supporting documentation such as time-sheets, COGS, purchase orders, and other related financial information. Authorities will scrutinize in particular:

Key areas:

- How each party benefited from the transaction;
- The necessity of services in question;
- The rationale for determining the price – was it done in accordance with the *Arm's Length Principle*?;
- And in the case of royalties, how much value the company derived from the use of the intangible assets.

Case Study: Transfer Pricing

Party A: Luxury Bag Seller

Party B: China Distributor

Party B is the sole distributor for luxury bags sold by Party A in China and are both wholly owned by the same headquarter company. Party B uses the Retail Price Method to determine the purchase price of bags from Party A with a **gross-markup to be 40%.** Party B sold more bags at full-price and less bags at a discount than expecting leading to a **real profit margin of 60%.**

A Post–Clearance Audit by Customs authorities determined the average mark-up for similar products to be 43% and that 60% could not reasonably be determined to be within the arm’s-length principle. In its transfer pricing report, Party B failed to establish that the relationship did not influence the price .

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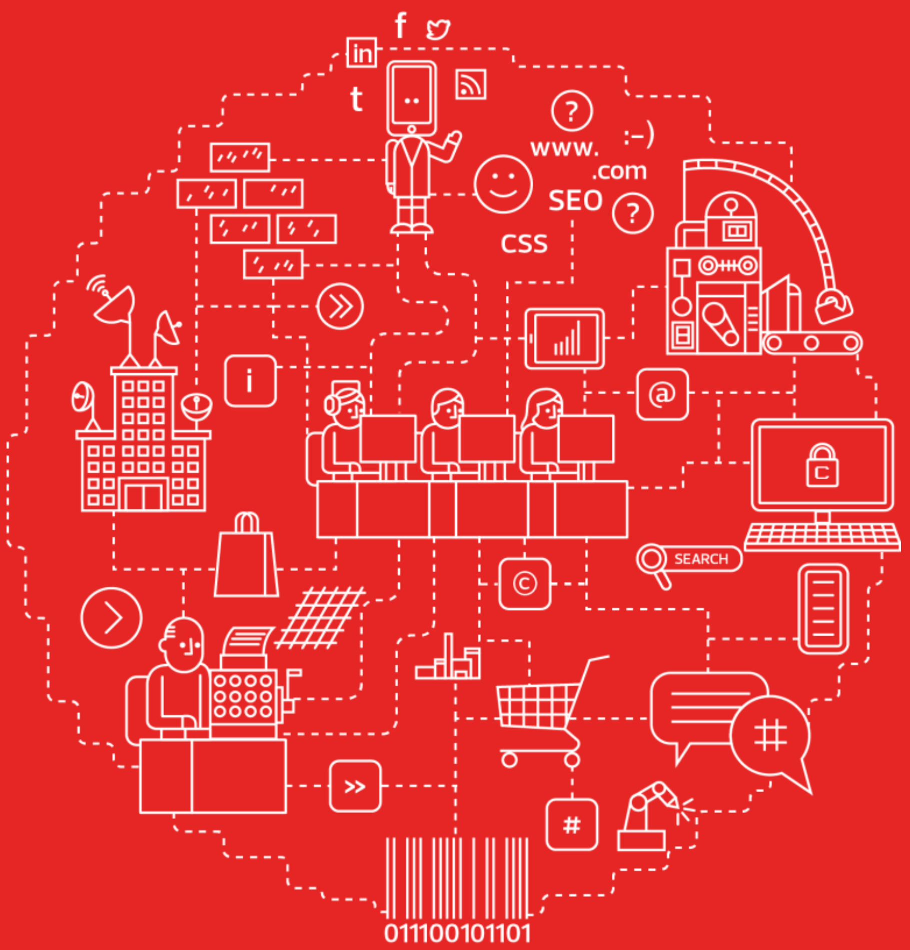

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